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BEFORE THE ARIZONA CORPORATION CC

COMMISSIONERS

Arizona Corporation Commission

DOCKETED

MAR 12 2007

MIKE GLEASON, Chairman  
WILLIAM A. MUNDELL  
JEFF HATCH-MILLER  
KRISTIN K. MAYES  
GARY PIERCE

DOCKETED BY

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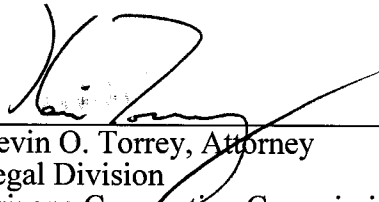
IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY  
FOR APPROVALS ASSOCIATED WITH A  
TRANSACTION WITH THE MARICOPA  
COUNTY MUNICIPAL WATER  
CONSERVATION DISTRICT NUMBER ONE

DOCKET NO. W-01303A-05-0718

NOTICE OF FILING  
STAFF'S REBUTTAL TESTIMONY

Staff of the Arizona Corporation Commission hereby files the Rebuttal Testimony of Gerald  
Becker of the Utilities Division, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 12<sup>th</sup> day of March, 2007.

  
Kevin O. Torrey, Attorney  
Legal Division  
Arizona Corporation Commission  
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Phoenix, AZ 85007  
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The original and thirteen (13)  
copies of the foregoing filed  
this 12<sup>th</sup> day of March, 2007, with:

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*monica A. Martin*

**BEFORE THE ARIZONA CORPORATION COMMISSION**

MIKE GLEASON

Chairman

WILLIAM A. MUNDELL

Commissioner

JEFF HATCH-MILLER

Commissioner

KRISTIN K. MAYES

Commissioner

GARY PIERCE

Commissioner

IN THE MATTER OF THE (REVISED) )  
APPLICATION OF ARIZONA-AMERICAN )  
WATER COMPANY, AN ARIZONA )  
CORPORATION, FOR APPROVALS )  
ASSOCIATED WITH A PROPOSED )  
TRANSACTION WITH MARICOPA COUNTY )  
MUNICIPAL WATER CONSERVATION )  
DISTRICT NUMBER ONE TO ALLOW THE )  
CONSTRUCTION OF SURFACE WATER )  
TREATMENT FACILITY KNOWN AS THE )  
WHITE TANKS PROJECT )  
\_\_\_\_\_ )

DOCKET NO. W-01303A-05-0718

REBUTTAL

TESTIMONY

OF

GERALD BECKER

PUBLIC UTILITIES ANALYST V

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

MARCH 12, 2007

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## ATTACHMENTS

Excerpt from the Audit Financials of Arizona-American Water Company Year Ended December 31, 2005.....	Appendix A
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**EXECUTIVE SUMMARY**  
**ARIZONA-AMERICAN WATER COMPANY**  
**DOCKET NO. W-01303A-05-0718**

Arizona-American Water Company ("Arizona-American" or "Company") is a public service corporation engaged in providing water and wastewater services in portions of Maricopa, Mohave, and Santa Cruz Counties, Arizona pursuant to various certificates of public convenience and necessity granted by the Arizona Corporation Commission ("Commission"). The Company currently serves approximately 100,000 water customers and 50,000 wastewater customers. The Company is Arizona's largest investor owned water and wastewater utility. Arizona-American Water Company is wholly owned by RWE. The Company's Agua Fria Water District serves approximately 30,000 water customers.

The Company's initial application requested approval to collaborate with the Maricopa Water District ("MWD") to finance, construct and operate a surface water treatment plant, but negotiations have ceased. Each party now states that resuming negotiations is unlikely. Thus, the Company intends to independently proceed with construction of the surface water treatment plant "White Tanks Project". However, the Company asserts that its financial situation will not allow it to attract the funds needed for this project. Accordingly, the Company proposes to increase its hook-up fee to a level sufficient to entirely finance the White Tanks Project.

Staff's review of the intervenors' testimonies revealed that there are valid concerns about the Company's financial condition. Staff normally considers a combination of Advances-In-Aid-of-Construction ("AIAC") and Contributions-In-Aid-of-Contribution ("CIAC") exceeding 30 percent of total capital as excessive. At December 31, 2005, combined AIAC and CIAC represented 35.47 percent of the Company's capital structure inclusive of AIAC and CIAC. The total estimated cost for the White Tanks Project is \$132.9 million which compares to Arizona-Arizonan's total debt and equity of \$329.2 million at December 31, 2005. Implementing the Company's request to fund the White Tanks Project entirely through increased hook-up fees would exacerbate the Company's already excessive use of AIAC and CIAC. Equity represented approximately \$104.5 million, or 30.8 percent of the Company's capital structure at December 31, 2005 (adjusted for a \$35.0 million equity infusion and a \$24.4 million goodwill write-off). Staff normally considers equity below 40 percent of total capital insufficient. Although Staff recommends approval of a hook-up fee sufficient to finance the entire surface water treatment plant in this proceeding, Staff also recommends re-examination of the hook-up fee in the Company's Agua Fria District 2008 rate case to consider a proper balance of long-term capital structure components.

The application also requests an accounting order to authorize two variances from established rate-making principles. First, the Company requests authorization to accrue post-in-service allowance for funds used during construction ("AFUDC") on any unfunded balance of the White Tank Project. Staff recommends approval of a variance to record post-in-service allowance for funds used during construction on the excess of the construction cost of the White Tanks Project over directly related hook-up fees collected through December 31, 2012, or the date that rates become effective subsequent to a rate case that includes 80 percent (based on

estimated cost) of the White Tanks Project in rate base, whichever comes first. Second, the Company requests that to the extent that cumulative collected hook-up fees exceed cumulative related construction expenditures, the excess hook-up fees should not be considered to be contributions until some corresponding eligible plant enters service. Staff recommends granting of a variance that excludes the excess of hook-up fees directly related to the White Tanks Project collected subsequent to the effect date of a decision in this case over the aggregate of (1) construction expenditures for the same period that are included in rate base and (2) any costs deemed imprudently incurred from contributions use to calculate rate base until December 31, 2012.

Staff recommends that approvals of the Company's requests for an increase in its hook-up fee and variances from established rate-making treatment be subject to the condition that Arizona-American agree that the Commission has complete authority to prescribe the entitlement and rate-making treatment of sales proceeds or other compensation from the sale or commitment, in whole or in part, of the White Tanks Project capacity to third parties.

The treatment of sales of capacity to a third party, whether existing main line extension agreements will be honored at existing rates, and the relevance of the estimated date of completion of the project are additional issues discussed in further detail in this testimony.

**INTRODUCTION**

**Q. Please state your name, occupation, and business address.**

A. My name is Gerald Becker. I am a Public Utilities Analyst V employed by the Arizona Corporation Commission ("ACC" or "Commission") in the Utilities Division ("Staff"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

**Q. Briefly describe your responsibilities as a Public Utilities Analyst V.**

A. I am responsible for the examination and verification of financial and statistical information included in utility rate applications and other financial matters before the Commission. In addition, I develop revenue requirements, prepare written reports, testimonies, and schedules that include Staff recommendations to the Commission. I am also responsible for testifying at formal hearings on these matters.

**Q. Please describe your educational background and professional experience.**

A. I received a Masters of Business Administration with an emphasis in Accounting from Pace University. I am a Certified Public Accountant and a Certified Internal Auditor.

I have participated in multiple rate, financing and other regulatory proceedings. I attended the National Association of Regulatory Utility Commissioners Utilities Rate School.

I began employment with the Commission as a utilities regulatory analyst in April 2006. Prior to joining the Commission, I worked as an Auditor at the Department of Economic Security and Department of Revenue in the Taxpayer Assistance Section. Prior to those jobs, I worked for 15 years as an Auditor, Analyst, Financial Analyst, and Budget Manager at United Illuminating, an investor owned electric company in New Haven, CT.

1 **Q. What is the scope of your testimony in this case?**

2 A. Arizona-American Water Company's (Arizona-American" or "Company") revised  
3 application, dated September 1, 2006, seeks (1) approval to increase its hook-up fee for  
4 the purpose of financing the building of the White Tanks Water Treatment facility solely  
5 through hook-up fees, and (2) an accounting order allowing Arizona-American to  
6 variances from established rate-making principles. Intervenor<sup>1</sup> have filed testimonies in  
7 response to the Staff Report, dated October 26, 2006, and/or in response to filings by other  
8 parties. I am presenting Staff's response to the financial and accounting issues presented  
9 in those testimonies.

10  
11 **BACKGROUND**

12 **Q. Please review the background of this application.**

13 A. Arizona-American is a public service corporation engaged in providing water and  
14 wastewater services in portions of Maricopa, Mohave, and Santa Cruz Counties, Arizona  
15 pursuant to various certificates of public convenience and necessity granted by the  
16 Commission. The Company currently serves approximately 100,000 water customers and  
17 50,000 wastewater customers in ten districts: Agua Fria Water, Anthem/AF Wastewater,  
18 Tubac, Sun City Water, Sun City West Water, Sun City Wastewater, Sun City West  
19 Wastewater, Anthem Water, Mohave, and Havasu. The Company is Arizona's largest  
20 investor owned water and wastewater utility. Arizona-American Water Company is  
21 wholly owned by RWE. Arizona-American proposes to build the White Tanks Water  
22 Treatment facility ("White Tanks Project") in the Company's Agua Fria Water District.

23  

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<sup>1</sup> The Residential Utility Consumer Office, Maricopa Water District, Trend Homes, Fulton Homes Corporation, Suburban Land Reserve, Westcor /Surprise LLC, CHI Construction Co., Courtland Homes Inc., Taylor Woodrow/Arizona Inc., Pulte Home Corporation.



1 In its original application, the Company proposed to collaborate with the Maricopa Water  
2 District ("MWD") but negotiations have failed and the parties are at an impasse. On  
3 October 27, 2006, Staff issued a report that stated that MWD was no longer interested in  
4 the project. More accurately, according to MWD, MWD is no longer interested in  
5 continuing negotiations with the Arizona-American but MWD continues its desire to  
6 build, own, and operate the treatment plant commonly known as the White Tanks facility.

7  
8 **ISSUES**

9 **Q. What are the primary accounting and operational issues brought forth by the**  
10 **intervenors related to Arizona-American's proposal (1) to increase its hook-up fee**  
11 **for the purpose of financing the building of the White Tanks Water Treatment**  
12 **facility solely through hook-up fees, and (2) for an accounting order allowing**  
13 **Arizona-American to variances from established rate-making principles?**

14 **A.** Staff has identified the following primary issues.

- 15 1. MWD's claimed alternative cost.
- 16 2. MWD's claim that hook-up fees as avoidable costs.
- 17 3. MWD's claim that adjustments to hook-up fees may require a rate proceeding.
- 18 4. The in-service date of the White Tanks Project.
- 19 5. Honoring main extension agreements.
- 20 6. Treatment of capacity sales to third parties.
- 21 7. Arizona-American's financial condition.
- 22 8. Departure from established rate-making principles.

**MWD's Claimed Alternative Cost**

**Q. What is MWD's claim regarding the cost of the White Tanks Project?**

A. MWD states that it can build the plant for lower costs and operate it for lower costs than Arizona-American due to its access to lower cost power and not having to pay property taxes. MWD also states that it can fund the project without the hook-up fees on which Arizona-America would rely. MWD also asserts that its cost of capital is less than that of Arizona-American.

**Q. What is Staff's assessment of the MWD's assertion regarding costs?**

A. Since MWD does not propose to use equity in its capital structure, the absence of what is normally the most costly component of capital should be a cost advantage for MWD over Arizona-American. However, MWD does not offer any commitments that any reduced costs will ultimately be passed to the end consumers. Municipal operations such as MWD enjoy not paying property taxes but this means that local and other taxpayers have to pay higher taxes to compensate for the amounts not assessed to a municipality. In effect, the ability to not pay property taxes does not represent a real gain to society as a whole. MWD has not presented support for its assertion that it has access to lower cost power. MWD's proposal has no provision for the collection of hook-up fees to defray the cost of the project. By not collecting hook-up fees, MWD would allow developers to circumvent paying an appropriate share of the capital cost, thus, placing upward pressure on rates.

The water treatment process is an integral part of the water supply process. If MWD builds the water treatment facility, it would not be under the auspices of a regulated entity and its activities would not be subject to examination by the Commission. MWD's response to Staff Data Request 1.4 states that it will charge rates based on contractual negotiations. This means that customers have no assurances that rates will not escalate

1 due to MWD charging market based rates and earning profits that could be considered  
2 excessive in a regulatory environment. Exposing regulated customers to the risk of  
3 market based pricing of water treatment is unnecessary and ill-advised.  
4

5 **MWD's claim that hook-up fees are avoidable**

6 **Q. What is MWD's claim regarding the financing of the White Tanks Project?**

7 A. MWD states that it can fund the project without the hook-up fees on which Arizona-  
8 America would rely. In response to Staff Data Request 1.6, MWD indicates that it will  
9 finance the construction of the plant through a combination of cash, tax exempt loans from  
10 the Water Infrastructure Finance Authority of Arizona ("WIFA"), or tax exempt project  
11 revenue bonds secured by one or a combination of net water treatment facility revenue, or  
12 bank letter of credit.  
13

14 **Q. What is Staff's assessment of the MWD's assertion regarding hook-up fees as**  
15 **unnecessary?**

16 A. Hook-up fees help to ensure that developers contribute an appropriate amount toward the  
17 construction of new facilities necessitated by development and to prevent harm to present  
18 ratepayers. MWD has neither the ability nor the intention to collect hook-up fees to cover  
19 capital investment in the White Tanks Project. This means that when capital recovery is  
20 to occur at a future date, capital recovery costs will be included in the treatment costs and  
21 reflected in the rates ultimately charged to ratepayers.  
22

**MWD's claim that adjustments to Hook Up Fees require a rate proceeding**

**Q. Does any intervenor say that adjustments to hook-up fees may require a rate proceeding?**

A. Yes. MWD states, "...the District is prepared to move quickly with this project. However, Arizona-American may not be able to move as quickly, because it may face legal challenges to the validity of hook-up fees upon which it relies. The Commission considers hook up fees to be rates.<sup>2</sup> .... Arizona-American's proposals violate the Commission's findings that hook-up fees cannot be imposed outside of a rate case unless the fee is: (1) revenue-neutral; and (2) is recorded as CIAC.<sup>3</sup> The special treatment for AFUDC and CIAC requested by Arizona-American violates these findings."

**Q. What is Staff's comment on MWD's statement?**

A. The comments of MWD are incomplete. MWD supports its position by reference to certain components of Decision No. 66512, but MWD does not state that the Commission ultimately approved the request to impose certain hook-up fees as part of Decision No. 66512, a non-rate proceeding. Paragraph 5 of the Conclusions of Law in Decision No. 66512 which immediately follows the one cited above by MWD states, "Under the circumstances of this case, and pursuant to Article XV, Sections 3 and 14 of the Arizona Constitution, Arizona-American's proposed hook-up fee tariffs, which will be booked as contributions in aid of construction, do not constitute rates that require a fair value determination prior to approval."<sup>4</sup>

<sup>2</sup> Footnote 24 in the Comments of the Maricopa Water District, November 16, 2006, which references "Decision No. 66512 (Nov. 10, 2003) at Conclusion of Law No. 4.

<sup>3</sup> Footnote 25 in the Comments of the Maricopa Water District, November 16, 2006, which references "Decision No. 66512 (Nov. 10, 2003) at Finding of Fact No. 10.

<sup>4</sup> Decision No. 66512, Page 5, lines 20-23.

**The In-Service Date of the White Tanks Facility**

**Q. Are Arizona-American and MWD ready to proceed to bring treated surface water to its customers in 2009?**

A. Arizona-American has a plan in place with a completion date of 2009<sup>5</sup> but has subsequently qualified its response. In response to Staff Data Request 3.2, the Company states, "As a result of the recent procedural schedule in this case, this updated schedule needs further revision." Staff recommends that the Company file an updated completion date prior to the hearing for this case.

MWD has a plan in place with a completion date of April 1, 2010.<sup>6</sup> However, as Arizona-American states, "By contrast, MWD offers only a preliminary design, but has no site; no permits; no canal improvement; no pipeline; no duty to serve; no customers; and no experience."<sup>7</sup> The District claims to already own land but has yet to finalize and disclose the selected site. Furthermore, MWD is unregulated and in the absence of contractual obligations, MWD could decide to cancel, postpone, sell, or condemn the facility without regulatory approval.

MWD's later completion date than Arizona-American's is relevant due to projected customer demand and the potential to avoid the costs to provide interim supply. Furthermore, MWD could decide to cancel, postpone, sell, or condemn the facility without consulting the Commission.

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<sup>5</sup> Company filing of November 22, 2006, Page 1, lines 12-13

<sup>6</sup> MWD response to Staff Data Request 1.2

<sup>7</sup> Company filing of November 22, 2006, Page 1, lines 13-14 and Page 2, 1-6

**Honoring Main Extension Agreements**

**Q. Are there existing Main Line Extension Agreements (“MXA”) in place in the White Tanks area?**

**A. Yes.**

**Q. What is Staff’s comment on the concerns expressed by intervenors regarding MXAs such as the following statement by Trend Homes, “On December 13, 2006, Trend filed comments requesting that it be made clear that to the extent that an applicant has already paid the WFHUF (Water Facility Hook Up Fee) under the existing tariff, that the Company be precluded from charging the difference between the existing WFHUF and the new WFHUF and that the Company be further precluded from unilaterally refunding WFHUF’s paid under the existing tariff (so that the new higher rate is required)”<sup>8</sup>?**

**A. Staff notes that Arizona-American must adhere to its authorized tariffs and honor the main extension agreements that have been submitted to and approved by the Commission. The Company must charge according to the tariffs that are in effect at that time. If the authorized tariffs are changed, the Company must charge the new tariffs upon their effective date and not retroactively.**

**Sale of Treatment Capacity to Third Parties**

**Q. Has any intervenor noted concern regarding the sale of water treatment capacity to other parties?**

**A. Yes, RUCO has expressed concerns about the treatment of any sale of capacity to third parties and states, “The application indicates that a third party may potentially purchase**

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<sup>8</sup> Comments of Trend Homes, Inc., December 13, 2006, Page 2, lines 206

1 capacity in the treatment plant. The Company needs to clarify how the hook-up fee will  
2 be modified in the event that this actually happened”<sup>9</sup>.

3  
4 **Q. Does Staff also have concerns regarding the impact of sales of capacity of the White**  
5 **Tanks Plant and treatment services to third parties?**

6 A. Yes.

7  
8 **Q. Has the Company presented a proposal to address the accounting/ratemaking**  
9 **treatment for all components of White Tanks Plant capacity sales?**

10 A. No, the Company has proposed a formula to adjust its hook-up fees to account for such  
11 transactions,<sup>10</sup> but the Company does not propose treatment for the proceeds from any sale  
12 of capacity in the plant.

13  
14 **Q. Does Staff have concerns regarding absence of proposed treatment of the proceeds**  
15 **from the sale or other commitment of the White Tanks Project capacity?**

16 A. Yes. The potential revenues from capacity sales are large relative to the size of the White  
17 Tanks Project, the rate base of the Agua Fria division and Arizona-American’s capital.  
18 Accordingly, the rate-making treatment of capacity sales is significant. For example,  
19 assume that the sales of capacity to third parties, hook-up fee collections and the cost of  
20 the White Tanks Project all equal \$132 million. In this circumstance, if revenues from  
21 capacity sales are treated as operating income for Arizona-American and these sales are  
22 not recognized in setting rates, the Company would experience a great windfall.  
23 Similarly, if the capacity sales revenue was used to refund hook-up fees offsetting CIAC,  
24 Arizona-American would gain the full value of the plant cost as an increase to rate base.  
25 The potential inequities that could result from not specifying how to treat capacity sales

<sup>9</sup> RUCO Notice of Filing, January 24, 2007.

<sup>10</sup> February 21, 2007, Testimony of Thomas M. Broderick, Page 7, Lines 7-25 and Page 8, Line 1.

1 demand that the issue be addressed in conjunction with the hook-up fee increase and  
2 accounting/rate-making variances requested by the Company in this proceeding.  
3 However, the rate-making treatment of capacity sales is best considered in a rate case  
4 proceeding.

5  
6 **Q. Does Staff have concerns regarding absence of proposed treatment of revenues**  
7 **generated by the provision of service to third parties?**

8 A. Yes. The concern over the rate-making treatment of revenues generated by the White  
9 Tanks Project to provide service to third parties is similar to the concern over the absence  
10 of a specified treatment for the sales of the White Tanks Project capacity. Revenue from  
11 treatment service to third parties is potentially significant and is best considered in a rate  
12 case proceeding.

13  
14 **Q. Does Staff have a concern with the Company's proposal to adjust hook-up fees?**

15 A. Yes. Staff's understanding of the Company's testimony<sup>11</sup> is that it proposes to reduce  
16 hook-up fees prospectively from the date of sale of White Tanks Project capacity to a third  
17 party. The Company's proposal is to reduce the hook-up fee by the amount calculated as  
18 75 percent of the difference between the hook-up fee approved in this proceeding and the  
19 existing hook-up fee multiplied by a factor that recognizes the relationship between  
20 Arizona-American's capacity use to the combined Arizona-American and third party  
21 capacity use. The latter factor also recognizes the relationship of Arizona-American and  
22 third party capacity use to total capacity. The Company asserts that the 75 percent factor  
23 is an incentive for it to secure capacity agreements with third parties. Proper assessment  
24 of the appropriateness of any incentive is predicated on knowing other factors such as the  
25 treatment of the proceeds and profit on sales of capacity and from providing third party

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<sup>11</sup> February 21, 2007, Testimony of Thomas M. Broderick, Page 6, Lines 18-25 and Page, Lines 1-4.



1 treatment. Since these other factors are unknown, the Company's proposal cannot be  
2 properly assessed.

3  
4 According to the Company's application, construction costs do not occur evenly as  
5 capacity increases. In its revised application, dated September 1, 2007, the Company  
6 describes, "...the latest cost estimates for the White Tanks Plant. For a 6.7 MGD plant,  
7 Arizona-American estimates a total cost of \$64,815,000. For the 13.5 MGD plant the  
8 estimated cost increases by just \$2,510,000 to \$67,325,000."<sup>12</sup> This means that the  
9 average cost for the first 6.7 MGD is approximately \$9.67 million per MGD. However,  
10 the average cost falls to \$4.99 million per MGD when the additional 6.8 MGD is included  
11 in the calculation. Thus, the projected average cost varies significantly with capacity.  
12 These factors complicate consideration of hook-up fee adjustment and are best considered  
13 in a rate case proceeding.

14  
15 **Q. What does Staff conclude regarding the treatment of sales of capacity to third**  
16 **parties?**

17 **A.** First, Staff concludes that it is premature to establish methodologies for the treatment of  
18 capacity sales for a plant that is yet to be built, since important relevant factors are yet to  
19 be determined such as: (1) the proposed price and amount of the capacity being sold; (2)  
20 the gross total expenditures to date; (3) total additional planned expenditures; (4) total  
21 hook-up fees collected; (5) projected future hook-up fees to be collected; and (6) treatment  
22 of any gain on the sales. Second, Staff concludes that a rate case proceeding is the best  
23 forum for considering the rate-making treatment of the sales of capacity of the White  
24 Tanks Project to third parties. Third, Staff concludes that a rate case proceeding is the  
25 best forum for considering the rate-making treatment of revenue generated by the White

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<sup>12</sup> Arizona-American Revised Application, September 1, 2006, Page 7, Lines 3-4.

1 Tanks Project to provide service to third parties. Fourth, Staff concludes that a rate case  
2 proceeding is the best forum for considering adjustments to hook-up fees. Fifth, Staff  
3 concludes that to facilitate consideration of sales of capacity, which may be considered a  
4 sale of utility assets under § 40-285, approvals of the Company's requests for an increase  
5 in its hook-up fee and variances from established rate-making treatment should be  
6 conditioned on Arizona-American's agreement that the Commission has complete  
7 authority to prescribe both the rate-making treatment of sales proceeds and the  
8 applicability of § 40-285 to any sale of capacity. Sixth, Staff concludes that gains on any  
9 sales of capacity of the White Tanks Project should be deferred to a rate case for  
10 disposition as authorized by the Commission. Finally, Staff concludes that consideration  
11 of the aforementioned items is necessary to protect ratepayers from potentially unjust  
12 enrichment for Arizona-American if the Company's requests for an increase in its hook-up  
13 fee and variances from established rate-making treatment are granted.

14  
15 **Arizona American's Financial Condition**

16 **Q. MWD states "Arizona-American's plan will only result in more financial**  
17 **weakness".<sup>13</sup> Please describe Staff's view.**

18 **A.** Staff agrees with MWD's statement that funding a major project entirely through hook-up  
19 fees could have a detrimental effect on the Company's capital structure. An excerpt from  
20 the Company's audited financial statements is attached as Appendix A. As of December  
21 31, 2005, the Company's audited financials indicate the following balances on which Staff  
22 has calculated the percentages shown:

	(000's)	Percentage
Common Stock Equity	\$ 93,854	28.51%
Short Term Debt	\$ 27,987	8.50%
Current Portion of Long Term Debt	\$162,964	49.51%
Long Term Debt	\$ 44,369	13.48%
Total Capitalization	\$329,174	100.0%

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<sup>13</sup> Company filing of November 22, 2006, Page 6, lines 8

Subsequent to December 31, 2005, the Company wrote-off Goodwill of \$24,364,784 and its parent company infused \$35,000,000 of equity into the Company. Both of these transactions affected Common Equity and the Total Capitalization. The adjusted pro forma results are shown below:

	(000's)	Percentage
Common Stock Equity	\$104,489	30.75%
Short Term Debt	\$ 27,987	8.24%
Current Portion of Long Term Debt	\$162,964	47.95%
Long Term Debt	\$ 44,369	13.06%
Total Capitalization	\$339,809	100.0%

Although the Company increased its equity percentage from 28.51 percent to 30.75 percent, the resulting equity level is below Staff's minimum recommended percentage of 40 percent.

In addition to the above data, the Company's financial statements indicate Contributions in Aid of Construction ("CIAC") and Advances in Aid of Construction ("AIAC") in the amounts of \$20,460,000 and \$160,475,000, respectively. Staff issued a Staff Report on October 6, 2006, in Docket No. W-00000C-06-0149 with regard to a generic evaluation of the regulatory impacts of non-traditional financing arrangements. That Staff Report recommended that CIAC and AIAC be limited to 30 percent of the total capital inclusive of CIAC and AIAC. A review of the Company's position, inclusive of the 2006 pro forma adjustments discussed above, indicates that the Company's combined AIAC and CIAC is 34.75 percent for the total. The data is shown below:

	(000's)	Percentage
Common Stock Equity	\$104,489	20.06%
Short Term Debt	\$ 27,987	5.38%
Current Portion of Long Term Debt	\$162,964	31.29%
Long Term Debt	\$ 44,369	8.52%

Total Capitalization	\$339,809	65.25%
AIAC & CIAC	<u>\$180,945</u>	<u>34.75%</u>
Total Capitalization plus AIAC/CIAC	\$520,744	100.0%

As indicated in this table, the combined, existing levels of AIAC and CIAC already exceed the recommended threshold of 30 percent. Also, the recalculation of Common Stock Equity as a percentage of the total capitalization inclusive of AIAC and CIAC further underscores the equity shortage.

Arizona-American's plan is to fund \$132.9 million White Tanks facility solely through hook-up fees, i.e., CIAC. The pro-forma effect of an additional \$132.9 million of CIAC on Arizona-American's capitalization plus AIAC and CIAC is shown below:

PRO FORMA \$132.9 M CIAC:	(000's)	Percentage
Common Stock Equity	\$104,489	15.99%
Short Term Debt	\$ 27,987	4.28%
Current Portion of Long Term Debt	\$162,964	24.93%
Long Term Debt	\$ 44,369	6.79%
Total Capitalization`	\$339,809	51.99%
AIAC & CIAC	\$313,835	48.01%
Total Capitalization plus AIAC/CIAC	\$653,644	100.0%

Other factors not reflected in this data such as the results of operations and additional equity infusions and/or distributions will also affect the Company's future capital structure. However, this data shows the detrimental impact of financing capital improvements exclusively with hook-up fees. Accordingly, Staff concludes that the hook-up fees authorized in this proceeding should be re-examined in the Company's Agua Fria division 2008 rate case to consider a proper balance of long-term capital structure components.

**Departure from Traditional Rate-making**

**Q. What departure from traditional rate-making principles is MWD referring to in its statement, "The Commission need not abandon its rate-making principles to encourage surface water use-it can have the best of both worlds."<sup>14</sup>?**

**A.** Arizona-American proposes to finance the White Tanks Project entirely through hook-up fees and states that it needs special accounting treatment in order to be made whole. The Company's application requests an accounting order to authorize two variances from established rate-making principles. First, the Company requests authorization to accrue post-in-service allowance for funds used during construction ("AFUDC") on any unfunded balance of the White Tanks Project, i.e., until the plant is fully funded by hook-up fees. Accepted rate-making practices required that AFUDC cease when plant enters service. Second, the Company requests that to the extent that cumulative collected hook-up fees exceed cumulative related construction expenditures, the excess hook-up fees should not be considered to be contributions until some corresponding eligible plant enters service. The Company supports the latter request by stating that while the plant is being built, the amounts expended will be in Construction Work in Progress ("CWIP"). Since CWIP is not in rate base, the Company seeks to exclude related CIAC, which reduces rate base according to established rate-making principles, from the rate base calculation until corresponding plant is in service.

**Q. What are some considerations related to the Company's requested accounting treatment?**

**A.** The reasonableness of a variance request should be evaluated on a case-by-case basis. Established rate-making practices have become accepted for good reason – essentially, in normal circumstances the normally recognized treatment is considered equitable.

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<sup>14</sup> Comment of the Maricopa Water District, November 16, 2005, Page 3, lines 23-24

1       However, some instances are unusual and call for a variance. As noted above, the  
2       projected capital required to finance the White Tanks Plant is relatively large in  
3       comparison to Arizona-American's existing capitalization. Typically, the advantages and  
4       disadvantages of the various leads and lags pertaining to the rate-making process tend to  
5       provide a balance that is equitable to investors and ratepayers. However, any imbalance is  
6       magnified by large variances from the normal activity. Accordingly, the White Tanks  
7       Project has the potential to introduce a significant imbalance due to its relatively large  
8       size.

9  
10       Arizona-American's first variance request addresses the potential that the Company may  
11       have a significant investment of its own capital invested in plant that is not earning a  
12       return. If such a scenario materializes, the Company's carrying cost for the lag between  
13       the time construction costs are paid and the time hook-up fees are collected may never be  
14       offset or recovered by future beneficial regulatory leads and lags. The Company's  
15       potential carrying cost must be weighed against other potential benefits. For example,  
16       Arizona-American would benefit from its application of AFUDC to CWIP balances to the  
17       extent the construction costs are financed by hook-up fees. Application of AFUDC to  
18       CWIP financed by non-investor funds has significant potential to offset any carrying costs  
19       that may occur on investor provided funds. However, AFUDC does not provide any  
20       direct source of cash to fund carrying costs such as interest expense and dividends.

21  
22       Arizona-American's second variance request addresses the potential for a rate base  
23       mismatch as a consequence of the hook-up fees it collects exceeding the plant that is  
24       completed and placed in service. Normally, hook-up fees recognized as CIAC are a  
25       deduction in the calculation of rate base, plant-in-service is an addition in the calculation  
26       of rate base and CWIP is not a component of the rate base calculation. Therefore, if a

1 portion of the hook-up fees is invested in CWIP and not yet transferred to plant-in-service  
2 at the time a rate case is processed, rate base is reduced by the excess of the CIAC over  
3 the plant additions. This rate base reduction is not harmful to the Company until the  
4 CWIP is transferred to plant-in-service since the Company can apply AFUDC to CWIP.  
5 However, when CWIP is transferred to plant-in-service, application of AFUDC  
6 terminates. Therefore, when rate base is reduced by CIAC that is funding CWIP and the  
7 CWIP is subsequently transferred to plant-in-service, the Company is no longer whole. A  
8 potentially offsetting benefit can occur to the extent that the Company collects hook-up  
9 fees and holds the fees as an investment before funding capital improvements.

10  
11 Another consideration is the Company's potential to benefit indirectly by the extensive  
12 use of hook-up fees to fund the White Tanks Project. This potential benefit comes from  
13 changing the mix of capital used to finance plant. An example can be used to illustrate  
14 this benefit. Assume that the Commission processes a rate case and determines that a  
15 utility's revenue requirement is composed of the following:

16

Item	Description	Percent
1	O&M Expenses	50%
2	Depreciation Expense	10%
3	Income Taxes	20%
4	Operating Income/ROR	30%
5	Total	100%

17  
18 In this example each revenue dollar is composed of 50 cents for O&M, 10 cents for  
19 depreciation expense, 20 cents for income taxes and 30 cents for operating income. Now  
20 assume the Company builds an identical expansion plant using only hook-up fees to serve

an anticipated doubling of customers. A similar calculation of the revenue requirement exclusively for the expansion plant could be calculated as follows:

Item	Description	Percent
1	O&M Expenses	100%
2	Depreciation Expense	0%
3	Income Taxes	0%
4	Operating Income/ROR	0%
5	Total	100%

The revenue requirement for the expansion plant includes no depreciation expense, income tax, or operating income. Since the expansion plant is built entirely with hook-up fees which are CIAC, there is no rate base upon which to earn resulting in no operating income. The absence of income eliminates income tax expense, and the depreciation expense is entirely offset by the amortization of CIAC. Arizona-American, by building the White Tanks Plant entirely with hook-up fees, is effectively eliminating from the revenue requirement components for depreciation expense and operating income to the extent the plant provides for expansion. However, since the Company will charge new customers the same rates as existing customers, it will collect the depreciation expense and operating income portions of the revenue requirement in those rates despite the absence of those components in its revenue requirement. Since Arizona-American's rates include recovery of all the revenue requirement components, its rates are not an accurate reflection of the White Tanks Project activity and may contribute to additional profits. Whether the operating costs for the White Tanks Plant will offset or negate these profits is unknown.



1    **Q.    What does Staff conclude regarding the Company's request for variances in**  
2       **accounting/rate-making treatment?**

3    A.    As previously discussed, the magnitude of the White Tanks Project has the potential to  
4       introduce a significant imbalance to the normal rate-making process due to its relatively  
5       large size. Staff concludes that this circumstance warrants granting of an accounting order  
6       authorizing the requested variances from established rate-making practices to provide  
7       some protection to the Company from potentially detrimental financial consequences.  
8       Staff comes to this conclusion with caution and some trepidation because the  
9       circumstances also present some benefits. Accordingly, authorization of variances should  
10      come with appropriate conditions to ensure a reasonable balance is maintained between  
11      the Company and ratepayer interests, as discussed below.

12  
13    **STAFF RECOMMENDATIONS**

14    **Q.    Please summarize Staff's recommendations.**

15    A.    Staff recommends the following:

- 16  
17       1.    Approval of the hook-up fee increase as recommended in the Staff Report, dated  
18           October 27, 2006, to provide adequate funds to Arizona-America to build the  
19           White Tanks Plant.
- 20  
21       2.    Re-examination of the hook-up fee in the Company's Agua Fria District 2008 rate  
22           case to consider, among other items, a proper balance of long-term capital  
23           structure components.

- 1           3.     That the Company file, prior to the hearing in this docket, updated information of  
2                 the target in-service date of the White Tanks Plant based on the most recent  
3                 information.
- 4
- 5           4.     Granting approval of a variance to record post-in-service allowance for funds used  
6                 during construction on the excess of the paid construction cost of the White Tanks  
7                 Project over directly related hook-up fees collected through December 31, 2012, or  
8                 the date that rates become effective subsequent to a rate case that includes 80  
9                 percent (based on estimated cost) of the White Tanks Project in rate base,  
10                whichever comes first.
- 11
- 12          5.     Granting approval of a variance that excludes the excess of hook-up fees directly  
13                 related to the White Tanks Project collected subsequent to the effect date of a  
14                 decision in this case over the aggregate of (1) construction expenditures for the  
15                 same period that are included in rate base, and (2) any costs deemed imprudently  
16                 incurred from contributions used to calculate rate base until December 31, 2012.
- 17
- 18          6.     Finding that the rate-making treatment of capacity sales of the White Tanks Project  
19                 to third parties should be determined in a future rate case.
- 20
- 21          7.     Finding that the rate-making treatment of revenue generated by the White Tanks  
22                 Project to provide service to third parties should be determined in a future rate  
23                 case.
- 24
- 25          8.     Finding that adjustments to the hook-up fee established in this proceeding should  
26                 be determined in a future rate case.

1           9.     Conditioning approvals of the Company's requests for an increase in its hook-up  
2                 fee and variances from established rate-making treatment on Arizona-American's  
3                 agreement that the Commission has complete authority to prescribe the entitlement  
4                 and rate-making treatment of sales proceeds or other compensation from the sale  
5                 or commitment, in whole or in part, of the White Tanks Project capacity to third  
6                 parties.

7  
8                 In addition, in the event that Arizona-American sells or leases, for any reason, any  
9                 capacity of the purposed plant, to include any future capacity enhancements, the  
10                Company agrees that any such transaction shall be predicated upon a filing of an  
11                application pursuant to A.R.S. 40-285.

12  
13           10.    Requiring deferral to a rate case of the gains on any sales of capacity of the White  
14                 Tanks Project for disposition as authorized by the Commission.

15  
16    **Q.     Does this conclude your direct testimony?**

17    **A.     Yes, it does.**

**ARIZONA-AMERICAN WATER COMPANY**  
**Balance Sheets**  
**For Years Ended December 31, 2005 and 2004**  
(Dollars in thousands)

**Capital and Liabilities**

	<b>2005</b>	<b>2004</b>
<b>Capitalization</b>		
Common stockholder's equity	\$ 93,854	\$ 95,258
Long-term debt (excluding current portion)	44,369	202,832
Total capitalization	138,223	298,090
<b>Current liabilities</b>		
Notes payable - associated companies	27,987	-
Current portion of long-term debt	162,964	4,524
Accounts payable	8,647	7,483
Accounts payable - associated companies	2,373	1,386
Accrued interest	1,281	1,295
Accrued taxes	1,844	941
Other	5,204	2,885
	210,300	18,514
<b>Long-term liabilities</b>		
Customer advances for construction	160,475	131,428
Deferred investment tax credits	68	71
Deferred revenue	3,865	4,034
Accrued pension expense	3,260	2,503
Accrued postretirement benefit expense	31	29
Other	332	378
	168,031	138,443
<b>Contributions in aid of construction</b>	20,460	16,474
<b>Commitments and contingencies</b>	-	-
	\$ 537,014	\$ 471,521

The accompanying notes are an integral part of these financial statements.